

THE QUARTER IN REVIEW

Rates, Midterms & Oil Still Cannot Tame This Market

By Kristian Colvin, CFP® • Emerson Equity, LLC

OVERVIEW

The third quarter saw modest equity gains, though for the year the S&P 500 was up by about 12 percent. With the price of oil up from the start of the year due to the Iran invasion, inflation has been on the rise. This has been difficult for bond investors with the Bloomberg US Aggregate Bond Index down 3.5 percent through this same period. Midterm elections are less than a month away and the uncertainty of the outcome is adding to market volatility. Our country's national debt crossed \$40 trillion with no sign of reversing course. The Fed raised interest rates and has its sights on another move upward this year. Artificial Intelligence (AI) spending and the well-to-do consumers have powered record earnings results for the first half of this year.

ENERGY

Oil Is Off Its Peak, but Fuel Costs Will Linger

Oil prices are currently 20 percent lower than their peak in April. The conflict with Iran began February 28 of this year and does not appear to have a resolution anytime soon. Higher oil prices have contributed to higher inflation. It is hard to track the flow of oil vessels through the Strait of Hormuz, but it is estimated that the flow of traffic is close to 80 percent of what it was before the invasion began. This is a great improvement from no vessels passing in April. Strategic reserves have been used aggressively to relieve higher oil prices. Diesel prices have been the most impacted fuel due to diesel refinery disruptions in the Middle East and Russia from their conflicts. Whenever these conflicts are resolved, we will likely still see higher fuel prices for months to come while infrastructure gets rebuilt and demand for oil remains high to refill strategic reserves.

THE QUARTER AT A GLANCE

Approximate figures cited in this issue

+12%

S&P 500, year-to-date through Q3

-3.5%

Bloomberg US Aggregate Bond Index, year-to-date through Q3

-20%

Oil price versus its April peak

+1.25%

Rise in intermediate and longer-term rates since January

\$40T

US national debt, crossed in August

+20%

Expected Q3 earnings growth, year over year

RATES & INFLATION

Inflation Turns the Fed Around

Inflation has been rising rather than falling, contrary to what was estimated at the start of this year. This has caused the Fed to change course and raise the Fed Funds rate with expectations to raise it one more time before the end of the year. At the start of the year, the Fed was expected to lower rates by as many as 2 times. This major change in outlook has caused intermediate and longer-term rates to increase by about 1.25 percent from the start of the year. If the price of oil does not spike again, we should see inflationary relief around the anniversary of the conflict with Iran. I am hopeful interest rates will settle where they are now. Historically, the 10-year Treasury bond is 1 to 1.5 percent above the Fed Funds rate, which is about where the rate curve stands now. This seems like a good time to add to bonds.

NATIONAL DEBT

\$40 Trillion, in Context

Our US national debt topped \$40 trillion in August with no slowdown in sight. This number is alarming, though not as scary as many might think. Our economic output is about \$32 trillion this year. 10 years ago, when our national debt was \$20 trillion, our economic output was around \$19 trillion. Our current debt represents about 20 percent of the total wealth in the US. I know very few would give up 20 percent of what we have to pay off this debt. Since many of us finance homes by borrowing 80 percent of the value, it makes it seem a little more manageable. When our government finally starts making difficult decisions to reduce expenditure and/or raise revenue, we can reverse course.

DEBT VS. ECONOMIC OUTPUT



“ *Markets do not care who is in power, just the certainty of an outcome.* ”

MIDTERM ELECTIONS

Markets Want Certainty

The midterm elections are less than a month away. Historically when one party is in full control of government, the House usually flips. This outcome has provided around 10 percent market returns for the next two years on average. Prior to the Iran invasion, the Senate did not seem to have a chance to go Democratic. Since then, there are some contests that are polling very competitive. If the Senate and the House were to both go to the Democrats, historically the market returns have been closer to 5 percent per year. Markets do not care who is in power, just the certainty of an outcome. Since the Senate has gotten more competitive, midterms will continue to add to market volatility until the results are final.

HISTORICAL MARKET RETURNS AFTER MIDTERMS

~10% House flips; average over the next two years	~5% House and Senate both flip; per year
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ARTIFICIAL INTELLIGENCE

AI: Careful What We Wish For

AI spending has never been higher than it is right now. If you believe corporate reports, spending is going to increase next year. Investment in AI data centers is currently about 2 percent of GDP. If you expand AI technology investment to beyond just tech centers, it could be as high as 8 percent of GDP. Near term, AI is a driver for our economy and corporate earnings. If successful to the level expected, it will be disruptive to employment. If AI cannot monetize their services at a level that they can pay their debts, it will be disruptive to our economy. Much of the capital expenditures that have been outlaid have been done by issuing debt. If OpenAI and Anthropic cannot receive enough revenue to service debt, they will not survive and we could see a debt crisis. This puts us in an uncomfortable situation of being careful what we wish for.

~2% of GDP Current investment in AI data centers	Up to 8% Including broader AI technology investment
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CORPORATE EARNINGS

Earnings at Levels Never Seen Before

2026 corporate earnings are delivering at levels never seen before at this juncture in an economic cycle. AI spending and well-to-do consumers are doing the lion’s share of the contributions. Second quarter earnings grew by nearly 40 percent year over year following stellar results from the first quarter at around 25 percent.

The bump up in the second quarter was due to a few one-time events such as tariffs and paper gains on investments from a few non-traded companies. Early 2025, President Trump announced his tariffs with ‘Liberation Day’, which caught corporations off guard. Unable to pass these expenses on to

consumers, they weighed heavily on their Q2 earnings. Early 2026 the Supreme Court ruled against the administration and ordered tariff rebates be issued, which landed in corporate results in Q2 2026.

Q3 earnings, which just began reporting, are expected to still be very good, up around 20 percent year over year. The banks were the first to report and results were a bit of a mixed bag, with Bank of America and JP Morgan coming in at the low end with around 13 percent year over year while Goldman Sachs’ earnings grew nearly 32 percent. Another strong earnings season will justify high equity multiples.



A CLOSING NOTE

I have given you a lot to read and hopefully think about. I look forward to reviewing how current economic and geopolitical events might impact your portfolio when we meet next.

Kristian Colvin

Emerson Equity, LLC
7946 Ivanhoe Ave. Suite 314
La Jolla, CA 92037

CONTACT
Phone: 858/551.8970
kcolvin@emersonequity.com
www.kristiancolvin.com

LET’S TALK
Questions about your portfolio? Call to schedule your next review.